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IN THE

Supreme Court of the United States

OCTOBER TERM, 1942.

No. 958

KENNEDY LAUNDRY COMPANY,
Petitioner,

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

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THE BUNTHORP-WARREN PRINTING COMPANY, 310 WEST JACKSON, CHICAGO

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

Kennedy Laundry Company, the petitioner, by James A. O'Callaghan, its counsel, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Seventh Circuit, entered in the above entitled case on February 15, 1943, reversing the decision of the United States Board of Tax Appeals.

Opinions Below.

The opinion of the Board (R. 32-37) is reported in 46 B. T. A. 70. The opinion of the Circuit Court of Appeals (R. 58-61) is reported in 133 F. (2d) 660.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on February 15, 1943 (R. 61). The jurisdiction of this court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented.

The petitioner took depreciation at the rate of 10% in its income tax returns for the years 1932 to 1936 inclusive. All these years showed losses. In 1937 (its first profit year since 1931), the petitioner changed to taking a rate of 8% for depreciation on its returns. The Commissioner acquiesced in the change and agreed that the life expectancy of the petitioner's machinery and equipment was 12½ years instead of 10 years. The question is: Can the petitioner readjust its unexhausted cost basis back through the loss years to 1932 and have added to its unexhausted cost basis in the year of change, the difference resulting from the 10% rate taken in its returns and the 8% properly allowable—the years of loss under the 10% rate being still years of loss under the 8% rate?

Statutes and Regulations Involved.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

Sec. 23. DEDUCTIONS FROM GROSS INCOME.

* * * * *

(1) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

* * * * * * *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * * *

Sec. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

* * * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *

* * * * * *

Sec. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

* * * * * *

The provisions of Sections 23 (1) and (n), 113 (b) (1) (B) and 114 (a) of the Revenue Act of 1938, c. 289, 52 Stat. 447, are the same as the corresponding provisions of the Revenue Act of 1936, above quoted.

The applicable regulations are Articles 23 (1)-1, 2, 4, 5 and 9, 113 (b)-1 and 114-1 of Treasury Regulations 94, relating to the 1936 Act, and of Treasury Regulations 101, relating to the 1938 Act.

Statement.

The Board of Tax Appeals found the following facts (R. 32-34):

The petitioner is a corporation organized in 1908. It is engaged in the laundry business. It filed its returns on the

accrual basis. In 1930, there was erected in its vicinity another laundry plant, which took business away from it, amounting to about $125,000 a year. In 1933, it lost a contract with the Atlantic and Pacific Tea Company, which meant a loss of business amounting to $125,000 to $150,000 a year. On account of these facts, the use of the petitioner's machinery was diminished by 30% to 40%. In its income tax returns for 1932, 1933, 1934, 1935 and 1936, petitioner claimed depreciation of machinery and equipment of 10%. In its income tax return for 1937, the petitioner changed the rate to 8%. The Commissioner agreed that the 8% rate was correct, but he also applied it to the year 1936, a year in which the petitioner showed a loss. There is no dispute between the parties as to the cost of machinery and equipment, nor as to the life expectancy of the assets. During the years 1932, 1933, 1934, 1935 and 1936, the petitioner's income tax returns showed a net loss for each year. In computing the unexhausted base of the machinery and equipment as of December 31, 1935, to determine depreciation for the subsequent years, the Commissioner used the amount resulting from the application of the 10% rate employed from 1932 to 1935, inclusive, instead of the 8%, which he agreed was the correct (allowable) rate.

The Board in its opinion agreed with the petitioner that the depreciation sustained during the loss years, 1932 to 1935, inclusive, should be computed at the 8% rate, and that the unexhausted base as of December 31, 1935, should be the amount of cost remaining after the rate was corrected for the loss years 1932 to 1935, inclusive, on the basis of 8% instead of the erroneous 10% used in the tax returns.

The Board further stated in its opinion that the rate of 8% for the period from 1932 to 1935, inclusive, was "reasonable" and should have been used. Further, that when the petitioner adopted the new rate of 8% in 1937, the

Commissioner approved it and applied it retroactively to the year 1936, thus corroborating the petitioner's contention that if the 8% rate was right for 1936 (a loss year), it was also correct in respect of the four prior loss years, and emphasizing that if the 8% rate was "reasonable" for 1936, as determined by the Commissioner, it was equally "reasonable" for the preceding period before which the change in operation, causing the lengthening of the life expectancy of the machinery and equipment, arose. The Board further found that the pertinent facts "*were*" known in 1932 and 1933, but were overlooked by the petitioner. Further, that the use of the 10% depreciation on the returns was merely an error on the part of the petitioner, which it corrected in 1937 (R. 35), but which it failed to correct back to 1932.

The Circuit Court of Appeals for the Seventh Circuit reversed the determination of the Board and followed the opinion of the Fourth Circuit in the similar case of *Helvering* v. *Virginian Hotel Corporation of Lynchburg*, 132 F. (2d) 909, decided on January 2, 1943, which, like the opinion in the instant case, is in direct conflict with the opinion of the Third Circuit, in *Pittsburg Brewing Co.* v. *Commissioner*, 107 F. (2d) 155.

Specification of Errors to Be Urged.

The Circuit Court of Appeals erred:

1. In holding that the petitioner was not authorized to go back and apply the 8% rate to all the loss years from 1932 to 1936, inclusive.

2. In sustaining the Commissioner's inconsistent position in going back and adjusting the unexhausted base for 1936 (a loss year) and refusing to do the same for the prior four loss years.

3. In reversing the decision of the Board.

4. In not holding that the petitioner had the right to correct its unexhausted depreciation base on facts which were known, but not acted upon in 1932.

5. In not holding the excess depreciation over the correct 8% was not allowed to the extent of the losses shown on the returns for 1932 to 1935 inclusive.

Reasons for Granting the Writ.

The decision of the court below in the instant case and of the Fourth Circuit in the *Virginian Hotel Corporation* case is in direct conflict with the decision of the Third Circuit in *Pittsburg Brewing Company* v. *Commissioner,* 107 F. (2d) 155.

The instant case involves the same depreciation question as is involved in *Helvering* v. *Virginian Hotel Corporation of Lynchburg,* in which case certiorari was granted on April 5, 1943, by this court, and that case is now pending in this court for disposition.

This case is on all fours with the *Virginian Hotel Corporation* case, except that the instant case has four added elements of strength in it. These added elements of strength are (a) the Board found as a fact that the petitioner knew in 1932 that the life expectancy of its machinery and equipment had increased, but failed through error in not reducing the annual rate of depreciation from 10% to 8%, and (b) that in changing the rate in 1937, it was not acting on knowledge acquired in that year, but was acting on information known as far back as 1932 but which it previously failed to use, and (c) had the petitioner acted on the information which it had in 1932, it would now be in the same position for which it is contending, and (d) the Commissioner, in adjusting 1936 to the 8% basis, concedes, in effect, that all the loss years back to 1932 should be readjusted on the basis of that same rate. In its final

analysis, the case involves, principally, the correction of a bookkeeping entry; that is to say, the correction of depreciation on the petitioner's returns back to 1932 in order to reflect the truth instead of error, and thereby follow through what the Commissioner did on the 1936 return.

Conclusion.

It is respectfully submitted that, in view of the conflict on this question between the Third and Seventh Circuits, and in view of the fact that certiorari has been granted in the *Virginian Hotel Corporation of Lynchburg* case, the writ in this case should be granted.

JAMES A. O'CALLAGHAN,
Counsel for Petitioner.

April, 1943.

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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 958

KENNEDY LAUNDRY COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

OPINIONS BELOW

The prevailing (R. 32–37) and dissenting (R. 37–41) opinions in the Board of Tax Appeals are reported at 46 B. T. A. 70. The opinion of the Circuit Court of Appeals (R. 58–61) is reported in 133 F. 2d 660.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered February 15, 1943 (R. 61). The petition for a writ of certiorari was filed April 26, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, in computing depreciation for the years 1936, 1937 and 1938, under Sections 23, 113 and 114 of the Revenue Acts of 1936 and 1938, the taxpayer's basis as of December 31, 1935, should be reduced by the amount deducted for depreciation in prior years in excess of that properly allowable where the excess was not offset by taxable net income for those years.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

* * * * *

(l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

* * * * *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

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SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

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(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, when-

ever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

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(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *

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(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

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The provisions of Sections 23 (l) and (n), 113 (b) (1) (B) and 114 (a) of the Revenue Act of 1938, c. 289, 52 Stat. 447, are the same as the corresponding provisions of the Revenue Act of 1936, above quoted.

The applicable regulations are Articles 23 (1)–1, 23 (1)–2, 23 (1)–4, 23 (1)–5, 23 (1)–9, 113 (b)–1 and 114–1 of Treasury Regulations 94, relating to the 1936 Act, and of Treasury Regulations 101, relating to the 1938 Act.

STATEMENT

The Board of Tax Appeals found the following facts (R. 32–34):

The taxpayer is an Illinois corporation, engaged in the laundry business. It filed its income tax returns on the accrual basis. (R. 32.)

In 1930 the taxpayer organized the Kennedy Laundry Company of Indiana, which erected a laundry plant in Gary, Indiana, and took over from the taxpayer's Pullman plant all Indiana business, amounting to about $125,000 a year. In 1933 the taxpayer lost its contract with the Atlantic & Pacific Tea Company and therewith business amounting to from $125,000 to $150,000 a year. On account of these facts, the use of the taxpayer's machinery was diminished by 30 or 40 per cent. (R. 33.)

In its income tax returns for 1932, 1933, 1934, 1935, and 1936 the taxpayer claimed depreciation on machinery and equipment at 10 percent (or a 10-year life). The returns preceding 1936 were not investigated and no changes therein were made by the Commissioner. In its income tax return for 1937 the taxpayer computed depreciation at 8 percent (or a 12½-year life). In his notice of deficiency the Commissioner approved the 8 percent rate adopted in the 1937 return, but applied it also to the year 1936. The taxpayer likewise used the 8 percent rate in its return for 1938, and such rate was allowed by the Commissioner. The parties agree that the basic cost figures relating

to the machinery and supplies appearing in the notice of deficiency and the schedules attached thereto are correct. (R. 33.)

From 1926 to 1931, inclusive, the taxpayer had net income. During the years 1932, 1933, 1934, and 1935 the taxpayer's returns showed net operating losses and depreciation items as follows (R. 33):

Year	Net operating loss	Total Depreciation	Depreciation on machinery and equipment
1932	$5,221.37	$22,387.60	$15,598.82
1933	2,643.26	17,278.24	14,716.59
1934	6,222.36	17,306.73	14,407.93
1935	5,385.88	17,694.44	14,363.71

The taxpayer's return for 1936 showed a net loss of $4,787.13. In determining the unexhausted base for the machinery and equipment items as of December 31, 1935, on which to apply subsequent depreciation at 8 percent, the Commissioner retained the 10 percent rate employed from 1926 to 1935, inclusive. (R. 33.)

The gross income reported by the taxpayer in its income tax returns for the years 1930 to 1938 is as follows (R. 34):

1930	$464,319.73	1935	$269,186.95
1931	370,074.72	1936	294,417.87
1932	279,043.96	1937	301,320.68
1933	282,635.91	1938	275,289.33
1934	265,624.44		

The Commissioner allowed depreciation on machinery and equipment in the sums of $3,871.37, $4,375.82, and $4,756.77 for the years 1936, 1937, and 1938, respectively (R. 34).

The taxpayer concedes that in any computation for later years the depreciation for the year 1933 should be increased so that the return for that year will show no gain or loss. The taxpayer reduced the depreciation allowances for the years 1932, 1933, 1934, and 1935 (years showing net loss) by applying the 8 percent rate. This treatment resulted in an unexhausted base of $49,568.02, as of December 31, 1935. By reason of such change of rate applicable to those years the taxpayer in its petition claimed depreciation of machinery and equipment amounting to $9,633.85, $10,138.30, and $10,627.55 for the years 1936, 1937, and 1938, respectively. These figures are subject to modification on account of the taxpayer's admission that the depreciation for 1933 should be increased. (R. 34.)

Upon review, the Board of Tax Appeals sustained the taxpayer (R. 36), four members dissenting (R. 37–41), but the court below reversed (R. 61).

DISCUSSION

The court below followed *Helvering* v. *Virginian Hotel Corp.*, 132 F. 2d 909 (C. C. A. 4th), which involves the same question.[1] Certiorari was granted in that case, No. 766, present term, and it

[1] The instant case, however, also presents the alternative issue whether, if the tax benefit theory obtains, the prior depreciation allowances did not contribute proportionately with all other deductions to offset income and therefore produced a tax benefit to that extent.

has been set for argument before this Court during the week of May 10. In the circumstances, we do not oppose the instant petition but suggest that the Court may wish to withhold action upon the petition until after disposition of the *Virginian Hotel* case.

Respectfully submitted.

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